FILED
U.S. Bankruptcy Appellate Panel of the Tenth Circuit

May 29, 2003

Barbara A. Schermerhorn Clerk

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE TENTH CIRCUIT

IN RE KIM L. WATSON, doing business as Okie Equipment Rentals, doing business as McGuire Plumbing; and GAYE D. WATSON, doing business as Okie Equipment Rentals, doing business as McGuire Plumbing, Debtors.	BAP No. WO-02-090
RURAL ENTERPRISES OF OKLAHOMA, INC., Plaintiff – Appellee, v. KIM L. WATSON and GAYE D. WATSON, Defendants – Appellants.	Bankr. No. 01-16224-BH Adv. No. 01-1298-BH Chapter 7 ORDER AND JUDGMENT*

Appeal from the United States Bankruptcy Court for the Western District of Oklahoma

Before BOULDEN, NUGENT, and THURMAN[1], Bankruptcy Judges.

THURMAN, Bankruptcy Judge.

The parties did not request oral argument, and after examining the briefs and appellate record, the Court has determined unanimously that oral argument would not materially assist in the determination of this appeal. Fed. R. Bankr. P. 8012. The case

* This order and judgment is not binding precedent, except under the doctrines of law of the case, res judicata, and collateral estoppel. 10th Cir. BAP L.R. 8018-6(a).

1 Honorable William T. Thurman, United States Bankruptcy Judge, United States Bankruptcy Court for the District of Utah, sitting by designation.

is therefore ordered submitted without oral argument.

Mr. and Mrs. Watson ("Debtors") timely appealed the United States Bankruptcy Court for the Western District of Oklahoma's final judgment excepting from discharge the debt owed by the Debtors to Rural Enterprises of Oklahoma ("Rural").[2] Rural sought to have the debt found nondischargeable under 11 U.S.C. § 523(a)(2)(B).[3] Rural argued that in order to induce it to lend the Debtors' company, Watson Rentals, Inc. ("WRI"), $150,000, the Debtors agreed to personally guaranty the loan. Rural argued that the Debtors submitted a financial statement containing fraudulent misrepresentations in support of the personal guaranty that it relied on in granting WRI the loan. Rural specifically argued that an omission of $1,300,000 in personal guaranties from the Debtors' personal financial statement was a fraudulent omission done intentionally to induce Rural to make the loan and that had Rural known of the guaranties, it never would have entered into the loan transaction.

The Debtors argued that the omission was not an intentional misrepresentation and that Rural, because of its knowledge of common lending practices to small businesses, should have known of the guaranties and, additionally, had the opportunity to discover their existence. The trial court ruled in Rural's favor and excepted the debt from discharge under § 523(a)(2)(B). For the reasons stated below, we conclude that the bankruptcy court's judgment is not clearly erroneous and is therefore AFFIRMED.

I. BACKGROUND

The Debtors are individuals who filed a joint Chapter 7 bankruptcy petition on June 18, 2001. The Debtors were the sole shareholders and officers of WRI and offered equipment rental services to the public under the name of Okie Equipment

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[2] See 28 U.S.C. § 158(a)(1); Fed. R. Bankr. P. 8002. The parties have consented to this Court's jurisdiction over this appeal because they have not elected to have it heard by the United States District Court for the Western District of Oklahoma. See 28 U.S.C. § 158(c).

[3] Unless otherwise stated, all statutory references are to title 11 of the United States Code.

Rentals or McGuire Plumbing.

WRI borrowed $150,000 from Rural in June, 2000 (the "Loan"), partially secured by personal guaranties from the Debtors. At the time of the Loan transaction, WRI had over $1,000,000 in existing SBA loans through another lender, Legacy Bank ("Legacy"). These loans ("Legacy Loans") were also personally guarantied by the Debtors ("Legacy Guaranties"). Prior to entering into the Loan with Rural, the Debtors had approached Legacy for additional funding but were denied. Legacy did, however, refer the Debtors to Rural, an intermediary lender of the Farmers Home Administration.

In order for WRI to qualify for the Loan, the Debtors were required to personally guaranty the Loan and submitted information and documentation consisting of a financial statement and the supporting documentation for the financial statement to support their guaranty. Jonrob Challacombe, a loan officer from Rural, gathered the information and conducted the evaluation of the loan application. The Debtors gave their personal accountant, Sheila Jones, authority to gather and provide any requested information. In addition, the Debtors gave Rural access to all the Legacy Loan information. However, the Debtors did not inform Rural about the Legacy Guaranties nor did Ms. Jones have any information about the Legacy Guaranties, and, in fact, was unaware of their existence, and, therefore, did not include any information regarding the Legacy Guaranties on the Debtors' personal financial statement. Mr. Challacombe prepared a credit memo that was submitted to Rural's board of directors for review, which ultimately approved the Loan, contingent upon the Debtors' guaranties of repayment of the debt.

Sometime after the debt was incurred, WRI dissolved and defaulted on the Loan. WRI also defaulted on the Legacy Loans and Legacy filed a lawsuit in state court seeking a judgment for approximately $1,300,000 against WRI, McGuire Plumbing and the Debtors in April 2001. The Debtors filed their bankruptcy petition in June 2001.

Following the filing of the bankruptcy case, Rural filed an adversary proceeding

seeking to have the obligation to it excepted from discharge under § 523(a)(2)(B).[4] Rural argued that the Debtors made false representations or recklessly failed to disclose the existence of the Legacy Guaranties in order to induce Rural to approve the Loan. Two Rural employees, Mr. Challacombe and Debbie Partin, testified that the Debtors did not disclose the existence of the Legacy Guaranties and had Rural been aware of them, it would not have approved the Loan to the Debtors. The Debtors argued that, although they personally did not tell Rural about the Legacy Guaranties, they did grant Rural access to all of the Legacy Loan documents and instructed their accountant, Ms. Jones to give Rural any information it required. However, the Debtors did not disclose to Ms. Jones the existence of the Legacy Guaranties.[5]

After a trial, the bankruptcy court entered judgment in favor of Rural holding that the debt to Rural was nondischargeable pursuant to § 523(a)(2)(B) in that the Debtors' personal financial statement was materially false because it did not disclose $1,300,000 in personal guaranties to Legacy.

II. DISCUSSION

The Debtors argue that the bankruptcy court erred in determining that there was sufficient evidence to warrant a finding that the omission of the Legacy Guaranties from their personal financial statement was a material misrepresentation made intentionally to induce Rural to grant the Loan.

Exceptions to discharge must be "narrowly construed" with doubt to be resolved in the Debtors' favor.[6] A creditor seeking to except a debt from discharge must prove

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[4] Rural also sought to have the bankruptcy court deny the Debtors a discharge under § 727. The bankruptcy court denied that aspect of the adversary proceeding, and that issue is not under appeal.

[5] There are no documents in evidence reflecting the actual personal guaranties on the Legacy Loans other than the Amended Petition in the state court action involving Legacy. However, the Debtors did list on their schedules an obligation to Legacy Bank for $1,300,000 for personal guaranties of business loans.

[6] See Bellco First Fed. Credit Union v. Kaspar (In re Kaspar), 125 F.3d 1358, (continued...)

each element of § 523(a)(2)(B) by a preponderance of the evidence.[7] Factual findings that a debt is statutorily nondischargeable are reviewed under the clearly erroneous standard.[8] "'A finding is "clearly erroneous" when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.'"[9] Additionally, Rule 8013 of the Federal Rules of Bankruptcy Procedure states that "[f]indings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witnesses."[10] We consider each of the Debtors' arguments under this standard.

First, § 523(a)(2)(B) states that:

> (a) A discharge . . . does not discharge an individual debtor from any debt–
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> . . .
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by–
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> . . .
>
> (B) use of a statement in writing–
>
> (i) that is materially false;
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> (ii) respecting the debtor's or an insider's financial condition;
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> (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

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6 (...continued)
1361 (10th Cir. 1997).

7 See Grogan v. Garner, 498 U.S. 279, 286-87 (1991).

8 See Watson v. Parker (In re Parker), 264 B.R. 685, 690 (10th Cir. BAP 2001), aff'd, 313 F.3d 1267 (10th Cir. 2002), pet. for cert. filed, 71 U.S.L.W. 3699 (U.S. April 25, 2003) (No. 02-1568).

9 Id. (quoting United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948)).

10 Fed. R. Bankr. P. 8013.

> (iv) that the debtor caused to be made or published with intent to deceive.[11]

Therefore, in order to find a debt nondischargeable under this section, a bankruptcy court must find, by a preponderance of the evidence, that "the debt was incurred: (1) using a written statement; (2) that is materially false; (3) respecting the debtor's or an insider's financial condition; (4) on which the creditor reasonably relied; and (5) that the debtor caused to be made or published with the intent to deceive."[12]

In the present case, it is not disputed that a written personal financial statement was provided by the Debtors to Rural to obtain the Loan to WRI, satisfying the first and third elements listed above. At issue at trial, and on appeal, is (1) whether the statement was materially false; (2) whether Rural reasonably relied on the financial statement in extending the Loan; and (3) whether the Debtors provided it to Rural with the intent to deceive. The bankruptcy court made factual findings to support each element in holding the debt nondischargeable and these findings should not be disturbed unless clearly erroneous.

A. Materially false statement

The bankruptcy court did not err in finding that the financial statement was materially false. "[A] statement need only be made with reckless disregard for the truth to make the underlying debt nondischargeable under § 523 (a)(2)(B). Further, '[t]he debtor's unsupported assertions of an honest intent will not overcome the natural inferences from admitted facts.'"[13]

A materially false financial statement contains "an 'omission, concealment or understatement as to any of the debtor's material liabilities.' In addition, the statement

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[11] 11 U.S.C. § 523(a)(2)(B).

[12] Skull Valley Band of Goshute Indians v. Chivers (In re Chivers), 275 B.R. 606, 613-14 (Bankr. D. Utah 2002).

[13] Central National Bank and Trust Co. v. Liming (In re Liming), 797 F.2d 895, 897 (10th Cir. 1986) (citation omitted) (quoting 3 Collier on Bankruptcy ¶ 523.09[5][b], at 523-62 (Lawrence P. King ed. 15th ed. 1981)).

must paint an untruthful picture of the debtor's financial condition in such a light which would normally affect the decision on the part of the creditor to grant credit."[14]

It is undisputed that the financial statement omitted the information regarding the Legacy Guaranties obligation totaling $1,300,000. The bankruptcy court found this omission to satisfy the materially false element of § 523(a)(2)(B). In making its findings, however, the bankruptcy court discussed the Debtors' net worth represented by the financial statement. The Debtors now argue that the omission of the Legacy Guaranties from the financial statement was not material because even if it had been disclosed, it would not alter the Debtors' net worth because it is a contingent liability. The Debtors seem to be arguing that because the existence of the Legacy Guaranties would not change the Debtors' net worth, the omission of the them from the financial statement cannot be a material omission. This argument is without merit. As discussed below, Rural relied upon a personal guaranty from the Debtors in its decision to lend the money. An omission of previously entered into guaranties of $1,300,000 is a significant omission and certainly "paints an untruthful picture" of the Debtors' financial condition. Furthermore, Debtors' argument that "contingent liabilities do not affect present net worth of an individual" is not supported by any evidence in the record or legal argument.[15]

B. Reliance

The bankruptcy court did not err in finding that Rural reasonably relied on the financial statement in its determination to grant the Loan. In order for a debt to be

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[14] Red Oak Branch of Farmers State Bank v. White (In re White), 167 B.R. 977, 979 (Bankr. E.D. Okla. 1994) (citations omitted) (quoting In re Harmer, 61 B.R. 1, 5 (Bankr. D. Utah 1984)); accord Bethpage Fed. Credit Union v. Furio (In re Furio), 77 F.3d 622, 625 (2d Cir. 1996); see also Candland v. Insurance Co. of North Am. (In re Candland), 90 F.3d 1466, 1470 (9th Cir. 1996) ("A statement can be materially false if it includes information which is 'substantially inaccurate' and is of the type that would affect the creditor's decision making process. . . . the creditor must show not only that the statements are inaccurate, but also that they contain important and substantial untruths.").

[15] Appellants' Brief at 6.

excepted from discharge under § 523(a)(2)(B), the creditor must first show that it actually relied on the financial statement and, second, that reliance must be reasonable.[16]

1. Actual Reliance

The bankruptcy court determined that Rural actually relied on the financial statement in making the Loan. The Debtors argue that Rural did not rely solely on the Debtors' guaranty, as represented by their financial statement because Rural also relied on a cash infusion from the Debtors, the Debtors' business cash flow and collateral with value sufficient to cover the Loan. In other words, Rural did not actually rely on the Debtors' personal financial statement in making the Loan because it was sufficiently covered by additional collateral to provide for its repayment. This argument is not persuasive. "[Section] 523(a)(2)(B) does not require that a creditor rely exclusively on the false financial statement. Partial reliance is enough. A lender can easily rely on a financial statement *and* a security interest in making a loan."[17]

Accordingly, in determining whether there was actual reliance, the bankruptcy court heard the following evidence before making its findings: (1) both Ms. Partin and Mr. Challacombe, the loan officers at Rural involved with the Loan, testified that Rural would not have made the Loan if it had known of the Legacy Guaranties; and (2) the credit memo generated by the loan officers to present to the board clearly indicates the Loan was to be secured by collateral and the personal guaranties of both debtors. There was ample evidence in the record from which the bankruptcy court could find actual reliance.

2. Reasonableness

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[16] See e.g., Field v. Mans, 516 U.S. 59, 68 (1995) ("Section 523(a)(2)(B) expressly requires not only reasonable reliance but also reliance itself"); Insurance Co. of North Am. v. Cohn (In re Cohn), 54 F.3d 1108, 1114-15 (3d Cir. 1995) ("Section 523(a)(2)(B)(iii), however, requires that the creditor *actually rely* on the debtor's statement. Accordingly, if it were reasonable to rely on a debtor's statement, but the creditor did not in fact rely upon the false statement, (B)(iii) would not be satisfied.") (emphasis in original).

[17] Liming, 797 F.2d at 897-98 (citations omitted) (emphasis in original).

In addition to actual reliance, a creditor's reliance on a written financial statement must be reasonable. The facts or circumstances of a case dictate the level of reasonableness a creditor will be charged with. "The standard of reasonableness places a measure of responsibility upon a creditor to ensure that there exists some basis for relying upon debtor's representations."[18] A creditor may not, then, simply bury its head in the sand and assume everything the debtor presents in his financial statement is accurate, but must take reasonable steps, depending on the circumstances, to verify the provided information.

There are situations, however, where a creditor may not be charged with a duty to affirmatively investigate a financial statement. The Tenth Circuit Court of Appeals has identified several situations where a creditor's reliance on the debtor's representations was deemed reasonable without additional verifying steps. These include the following: (1) cases involving "ongoing relationships between the debtor and creditor"; (2) cases where "statements contained no information indicating that further investigation was required"; (3) cases where there is "no indication that further investigation would have uncovered the falsity of the representations"; or (4) cases where "the asserted failure to verify occurred after the loan had been made."[19] It is also true that "a showing of the debtor's dishonesty is simply not sufficient to prevent

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[18] Leadership Bank v. Watson (In re Watson), 958 F.2d 977, 978 (10th Cir. 1992) (quoting First Bank v. Mullet (In re Mullet), 817 F.2d 677, 679 (10th Cir. 1987), abrogated in part on other grounds, Field v. Mans, 516 U.S. 59, 63 n.4 (1995)).

[19] Mullet, 817 F.2d at 681; see also Coston v. Bank of Malvern (In re Coston), 991 F.2d 257, 261 (5th Cir. 1993) (en banc) (per curiam) ("[R]easonableness . . . should be judged in light of the totality of the circumstances. . . . consider[ing], among other things: whether there had been previous business dealings with the debtor that gave rise to a relationship of trust; whether there were any 'red flags' that would have alerted an ordinarily prudent lender to the possibility that the representations relied upon were not accurate; and whether even minimal investigation would have revealed the inaccuracy of the debtor's representations."); Bank of Commerce v. Smith (In re Smith), 278 B.R. 532, 537 (Bankr. N.D. Okla. 2002) ("The reasonableness of a creditor's reliance under § 523(a)(2)(B) is judged by an objective standard, i.e., that degree of care which would be exercised by a reasonably cautious person in the same business transaction under similar circumstances.").

discharge under § 523(a)(2)."[20] Therefore, Rural must show that it reasonably relied on the financial statement in agreeing to extend the Loan and not just, after the fact, argue that the financial statement, with its omission of the Legacy Guaranties, induced Rural to make the Loan.

The Debtors argue that Rural was not reasonable in its reliance because it was given access to all the documents from Legacy Bank and could have discovered the Legacy Guaranties. In addition, the Debtors argue that normal lending practices to small businesses require guaranties as a general rule. Being aware of these lending practices, Rural should have known that Legacy would have required guaranties in making its loans and, therefore, Rural could have discovered the Legacy Guaranties' nature and existence. Finally, the Debtors argue that they gave their accountant the responsibility to provide any needed information and did not deliberately conceal information.

The Debtors' arguments are unpersuasive. The bankruptcy court found that Rural reasonably relied on the financial statement in making the decision to lend the money. The Debtors, through their accountant, provided a financial statement to the Bank. The bankruptcy court found that Rural reasonably relied on the financial statement to its detriment. We cannot conclude that the bankruptcy court was clearly erroneous in making this finding.[21]

According to Mullet, one of the situations where a creditor is deemed to reasonably rely on a financial statement without additional investigation is the situation that exists when nothing in the financial statement alerts the creditor that further investigation may be necessary. If a creditor is presented with certain "red flags," such

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[20] Mullet, 817 F.2d at 682.

[21] The bankruptcy court correctly identified the standard of "reasonable reliance" as the standard employed under § 523(a)(2)(B). (Appellants' Appendix at 0293.) However, the court also stated that the "bank was justified in relying upon the personal financial statement it obtained." (Appellants' Appendix at 0294.) Although the bankruptcy court used the word "justified," it is clear from the record that it made its findings under a "reasonable reliance" standard and not a "justifiable reliance" standard.

as discrepancies in information, then the creditor must take further investigative steps to verify the information in order to be able to reasonably rely on the financial statement.[22]

Rural was given a financial statement and was given access to the Debtors' accountant. No "red flags" appeared to indicate to Rural that the financial statement should be further investigated, and, in fact, even if there had been a "red flag," the accountant would not have been able to provide any information about the Legacy Guaranties because the accountant was unaware of and did not have access to that information. In addition, although Rural was given access to the Legacy Loan documents, the evidence before the bankruptcy court was that Rural was not able to get much information from Legacy, and, in fact, had no reason to do so because of the reasonableness of the information in the financial statement itself. The Debtors argue that because Rural had access to the Legacy Loans' information that Rural should have checked all the documents to verify the provided financial statement. This seems unreasonable to require a creditor to affirmatively investigate numerous documents to verify a financial statement it had no reason to question. This type of affirmative investigation goes beyond the "reasonableness" required by § 523(a)(2)(B).

Further bolstering Rural's reasonableness is its prior relationship with Legacy Bank. Rural's loan officer, Mr. Challacombe, testified that the Debtors were referred to Rural by Legacy and that Legacy's loan officer was optimistic about the situation but was unable to provide funding at the time. However, Legacy recommended the Debtors and said they were "good customers."[23]

As listed above, the Tenth Circuit has identified an ongoing business relationship among those categories of situations where further investigation into a financial statement

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[22] See Leadership Bank v. Watson, 958 F.2d at 980 ("Further, there was nothing in the financial statement which should have alerted the Bank that further investigation was necessary. The financial statement did not contain any inconsistent information nor did it contain any noticeable discrepancies which would have alerted the Bank that the financial statement might be inaccurate or incomplete.").

[23] Appellants' Appendix at 0246.

is not required.[24] While the Debtors were new customers to Rural, they came recommended by Legacy. Rural was not given any kind of "red flags" or notice of potential problems from Legacy and relied on its representations in addition to the information provided in the financial statement. This is not unreasonable.

The Debtors also argue that Rural should have known of the Legacy Guaranties' existence because of its knowledge of lending practices to small businesses. The Debtors assert that because Rural is aware that lenders typically ask for a personal guaranty when lending to small businesses that it should have inquired to determine whether the Legacy Loans were personally guarantied by the Debtors. Although the bankruptcy court expressed some skepticism regarding Rural's lack of knowledge regarding the Legacy Guaranties in light of Rural's lending practices, the court went on to find Rural's reliance reasonable in light of the overall financial picture painted by the Debtors' financial statement.

The bankruptcy court was not clearly erroneous in this finding. No evidence was presented to the bankruptcy court regarding the actual lending practices of institutions that commonly lend to small businesses other than testimony provided by Rural's loan officer, Mr. Challacombe. The following interchange occurred between Mr. Challacombe and Debtors' counsel:

> Q: It would be unusual, wouldn't it, for REI to loan money to any corporation without a personal guarantee?
>
> A: Pretty much.
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> Q: Okay. That would be highly unusual for any bank to loan money to a corporation without a personal guarantee.
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> A: Not necessarily.
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> Q: Have you seen that done?

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[24] See Watson, 958 F.2d at 979.

A: It just – it just depends on the situation.[25]

There was an additional exchange between the bankruptcy court and Mr. Challacombe wherein the Court questioned him about Mr. Challacombe's interaction with Legacy Bank regarding this Loan. The Court stated: "Well, did you ever ask them if they had guaranteed – I assume it's rather common in the industry for a small businesses like this that the owners will guarantee loans, and officers and directors. You've already said that."[26] Mr. Challacombe only responded that in his conversation with Legacy, no guaranty was discussed.

There is no other evidence in the record to support the Debtors' argument regarding lending practices to small businesses. In light of the other evidence of reasonable reliance, the above evidence does not support a conclusion that the bankruptcy court's findings were clearly erroneous. This is further supported by the evidence that even if it is a common lending practice, if Rural had inquired of the Debtors' accountant, she would not have revealed the existence of the Legacy Guaranties since she was unaware of them. The Debtors gave their accountant authority to provide any and all information required by Rural, but did not divulge to her the existence of the Legacy Guaranties.

C. Intent to Deceive

Finally, the bankruptcy court did not err in finding that the Debtors provided the financial statement with an intent to deceive. The bankruptcy court found that the intent to deceive element was met by the testimony of Mr. Watson that the Debtors relied entirely on their accountant to prepare the financial statement but never revealed to the accountant the existence of the Legacy Guaranties. Further, when the other elements

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[25] Appellants' Appendix at 0234-35.

[26] Appellants' Appendix at 0244.

under § 523(a)(2)(B) are met, the intent to deceive element may be inferred.[27] The bankruptcy court determined that the Debtors provided the financial statement containing the material omission either knowingly or recklessly, thus satisfying this element.

The evidence before the bankruptcy court was that the Debtors' accountant, Sheila Jones, was charged with preparing and providing the Debtors' personal financial statement. Ms. Jones testified that she was not aware of the Legacy Guaranties. It seems odd that the Debtors would not provide this type of financial information to their accountant noting its size, which suggests additional recklessness on the part of the Debtors in the loan process. Accordingly, the bankruptcy court was not clearly erroneous in finding that the Debtors, either knowingly or recklessly, provided a false representation with the intent to deceive.

III. CONCLUSION

For the reasons stated above, the bankruptcy court was not clearly erroneous in excepting the debt from discharge under § 523(a)(2)(B). The Judgment is AFFIRMED.

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[27] See Driggs v. Black (In re Black), 787 F.2d 503, 505-506 (10th Cir. 1986) ("requisite intent may be inferred from a sufficiently reckless disregard of the accuracy of the facts"), abrogated on other grounds, Grogan v. Garner, 498 U.S. 279 (1991); see also Carini v. Matera, 592 F.2d 378, 380 (7th Cir. 1979) (per curiam) ("Indeed, where, as here, a person knowingly or recklessly makes a false representation which the person knows or should know, will induce another to make a loan, intent to deceive may logically be inferred.")